MINUTES
of the
SECOND MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

July 21, 2015
Room 307, State Capitol
Santa Fe, New Mexico

The second meeting of the Investments and Pensions Oversight Committee (IPOC) for the 2015 interim was called to order by Representative Monica Youngblood, vice chair, on Tuesday, July 21, 2015, at 8:45 a.m. in Room 307 of the State Capitol in Santa Fe.

Present
Sen. George K. Munoz, Chair
Rep. Monica Youngblood, Vice Chair
Sen. Sue Wilson Beffort
Rep. Miguel P. Garcia
Rep. Larry A. Larrañaga
Sen. Bill B. O'Neill
Rep. William "Bill" R. Rehm
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Sen. Jacob R. Candelaria
Sen. Carroll H. Leavell
Sen. Steven P. Neville
Rep. Jane E. Powdrell-Culbert
Sen. William P. Soules

Advisory Members
Sen. Ted Barela
Sen. Stuart Ingle
Sen. John C. Ryan

Sen. Carlos R. Cisneros
Rep. Roberto "Bobby" J. Gonzales
Rep. Patricia A. Lundstrom
Sen. Mary Kay Papen
Sen. William H. Payne
Rep. Tómas E. Salazar
Sen. Michael S. Sanchez
Rep. James E. Smith
Rep. Sheryl Williams Stapleton

Staff
Lisa Sullivan, Staff Attorney, Legislative Council Service (LCS)
Ric Gaudet, LCS
Amy Chavez-Romero, Assistant Director for Drafting Services, LCS

Guests
The guest list is in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

Tuesday, July 21

Update on the Deferred Compensation Plan Administered by the Public Employees Retirement Association (PERA)

Wayne Propst, executive director, and John Grabel, chief investment officer, PERA, presented to the committee an update of the PERA tax-deferred compensation plan. Mr. Propst described a deferred compensation retirement savings plan as one of the three legs of a sturdy pension stool; the other two legs being a defined benefit plan and social security. The PERA pension plan for public employees in New Mexico is one of the best defined-benefit plans in the nation, and the optional deferred compensation plan is a great choice for employees. The PERA administers member contributions to the plan using the same fiduciary standard that governs the regular pension plans, instead of the commonly used "suitability standard", which only requires that investments be suitable for the member, rather than always be in the member's best interests.

Members currently have 19 investment strategy options, ranging from passive to active member involvement. Mr. Propst said that the PERA tries to get members to think more about asset allocation and less about branding. Generally, the most beneficial long-term strategy for members to choose is a life cycle portfolio, in which a member's funds are invested into a custom asset allocation proportion according to the member's age and expected year of using the funds. Members who want a more active role in investing their funds have many allocation options available. Members pay a low annual administrative fee of $52.00, except for those members who are just starting the plan, for whom the fee is waived. Investment management fees are also low, due to the fact that members are paying an institutional rate rather than a typical retail rate if their money were to be invested in a branded fund. Management fees for the last fiscal year were 42 basis points, lower than the national median expense rate.

The PERA has more than 18,000 public employees enrolled in the deferred compensation plan, with 219 employers participating. More than $500 million has been invested by the PERA on behalf of the participants. The PERA is attempting to increase the number of employers participating and the number of members investing in the next few years. A new enrollment form has been created, making it much easier to sign up for the plan, and the name of the program will be changed to make it more identifiable as a state-run retirement plan.

Questions and comments from committee members included the following.

- Are school employees allowed to join the deferred compensation plan, even though they are covered by the Educational Retirement Act? Mr. Grabel said that all school districts are eligible to participate in the plan, but the only school district that has opted into the plan is the Albuquerque Public School District.

- Why are members charged two different fees? Mr. Grabel said that the $52.00 administrative fee is used to cover the expenses of administering the plan, including recordkeeping, preparation of statements, payroll deductions, customer support and outreach. As more members join the deferred compensation plan, that fee will be reduced. Investment fees are kept by mutual fund companies that make the actual investments and are charged at institutional rates.
- Can tax-exempt nonprofit organizations join the plan? Susan Pittard, chief legal counsel, PERA, said that those organizations are allowed under federal law to participate in such programs, but New Mexico's Deferred Compensation Act currently only allows for governmental entities to join the state plan.
- Does the deferred compensation plan have the same performance as the regular PERA pension plan? Mr. Grabel said that most members choose investment options that typically underperform optimal allocations by one to two percent. People tend to choose too many equity plans, rather than a real asset allocation across classes.
- Are there annual limits on how much can be invested and tax deferred? Mr. Grabel said that the Internal Revenue Service annually publishes contribution limitations. With a few exceptions, this year's limit is $18,000.
- How often can a member change asset allocation strategies? Mr. Grabel said that a member can change asset options at any time; however, it may take a few weeks for the changes to be implemented. Mr. Propst said that there are three pillars of investing: time in market, contributions and asset allocation. The PERA, however, does not give specific investment advice to its members.
- Do any investments made by the PERA have any relationship with Donald Trump? Mr. Grabel said that he was not aware of any direct involvement.
- Are return-to-work employees eligible to make contributions to the plan? Mr. Propst said that he believed that they are eligible but he would check and report back to the committee.

Analysis of Investment Management Fees Authorized by the PERA

Mr. Grabel provided the committee with a discussion of how the PERA oversees fees charged by its investors. In July 2014, the PERA board directed staff to perform a comprehensive review of the value of its money manager relationships. There are currently no industry-wide standard methodologies to assess fees. Discrepancies in how fees are reported include that incentive fees are often ignored; some performance measures are reported as gross of fees and some are reported as net of fees; fee analyses are often not adjusted according to asset type; and fees are often reported without any context of risk-adjusted performance. PERA staff developed its own methodology to study its fees that included performance benchmarks, peer comparison, risk measures and fees paid for each manager of its funds.

In fiscal year 2014, the PERA fund returned 17 percent and gained in value by more than $2.1 billion. It paid $70.8 million in management fees, or fees that are paid based on the value of the asset, and $48.4 million in performance fees, which are based on profit-sharing. The PERA hired CEM, a third-party benchmarking service, to compare the management fees paid by the

PERA to other similar funds. CEM found that the benchmark, or expected, basis fee level for a fund the size of the PERA's would be 70 basis points. In actuality, the PERA paid only 59 basis points, representing a savings of approximately $15 million. CEM ranked the PERA fund among the best category of funds: positive value-added and low cost. The study ranked most asset categories held by the PERA as efficient, including U.S. equity, foreign equity, fixed income, real estate and real asset.

The CEM study was subsequently used by the PERA to fine-tune the management in several asset categories. For example, in the domestic equity category, the PERA eliminated three managers and positioned the portfolio to achieve a higher Sharpe ratio (a measurement of earnings versus risk). In the portable alpha sector of the absolute return asset category, the PERA made significant changes to the portfolio, including reducing investment managers from 19 to one manager, achieving better liquidity and reducing management fees by $5 million.

In conclusion, Mr. Grabel said that the PERA has a positive fee investment structure. He cautioned, however, that fees comprise a very small portion of overall investment outcome and that asset allocation accounts for 90 percent of investment returns. Seeking low fees should not be the sole basis of an investment decision.

Questions and comments from committee members included the following.

- Has there been a study comparing the investment outcomes of the PERA, State Investment Council (SIC) and Educational Retirement Board (ERB)? The legislature needs to be informed of how each agency is performing, compared to each other and to the rest of the country. Mr. Propst said that the Legislative Finance Committee (LFC) produces quarterly investment reports for the three agencies. Each agency has different financial obligations and goals, so making broad investment comparisons is not always useful.
- The investment management study set in motion a method for the PERA to continually improve investment performance vis-à-vis fees. This is an excellent idea.
- Can the PERA study the exposure the PERA fund has to various global risks? Mr. Grabel said that the PERA produces a monthly basis valuation study plus an annual benchmark review to ensure that its investments are performing adequately. In addition, all assets can be reviewed on a daily basis to measure risk, liquidity and other factors. The PERA can now also do much more scenario testing. For example, it was able to test its exposure in Greece during its recent economic turmoil in order to measure the PERA's risk in that market.
- PERA staff was asked to provide the committee with much more detail about every investment manager, including amounts under contract, fee rates and actual investments made.
- The CEM study did not study performance fees and, as a result, only a partial picture of the fees paid by the PERA was provided. Mr. Grabel said that CEM is currently

developing a methodology to study performance fees, and the PERA will contract with that company to study its performance fees.

- Does the PERA pay any third-party marketing fees? Mr. Grabel said that the PERA does not pay such fees. Some of its investment managers may pay placement fees, which fees are disclosed quarterly.
- The PERA is paying tens of millions of dollars annually in investment management fees. Some states are using in-house investment managers, rather than outside contractors, with similar results. Mr. Grabel said that in many cases, the economies of scale and information-gathering edge associated with using a large investment firm outweigh any management fee savings by using in-house staff to manage investments.

Analysis of Investment Management Fees Authorized by the ERB

Bob Jacksha, chief investment officer, ERB, discussed with the committee investment management fees paid by the ERB. Mr. Jacksha began by discussing a presentation at the June IPOC meeting at which the fees paid by the ERB appeared to be much higher than the SIC's fee structure. The main reason the ERB fees appeared higher is because the ERB fees included performance fees, whereas the SIC data only included management fees. Another difference in the data is that the method to calculate basis points used different kinds of asset totals. The ERB data used net asset value to determine fees, but the SIC data also included unfunded commitments, resulting in lower apparent fees. When the fee structure of the two entities is compared using similar data, the ERB's fee structure is much more comparable to the SIC's.

For fiscal year 2014, the ERB paid 96 basis points for alternative investments and 25 basis points for traditional investments, for a weighted average of 66 basis points for the entire portfolio. This fee structure is very similar to the SIC's December 2013 reported fee structure of 61 basis points, rather than the misleading figure of 80 basis points previously reported.

Mr. Jacksha said that the ERB hired a consulting firm to study management fees paid. The results of the study showed that the ERB is getting a good return for the fees it pays. The ERB seeks to minimize fees, but not at the expense of performance. Asset allocation is the primary factor in the level of fees as well as overall portfolio performance. The net return of an investment is more important than the amount of fees actually paid, as is the amount of risk exposure a portfolio has.

Questions and comments from committee members included the following.

- Does the ERB prohibit third-party placement fees? Mr. Jacksha said that the ERB allows its investment managers to pay third-party marketers if they wish to, but each such contract and fee paid must be disclosed.
- Mr. Jacksha was asked to explain the recent New Mexico Supreme Court ruling in one of the "pay-to-play" lawsuits. Mr. Jacksha said that the ERB has a pending lawsuit against Aldus, in which placement agent fees were not disclosed to the ERB. The recent Supreme Court ruling pertains to what is known as the "Foy" lawsuit, in

which the ERB is not a direct litigant. The ERB does stand to benefit from the case if the state prevails. In that case, the court ruled that the case may proceed, and the defendants may be liable for restitution.

- Does the ERB pay fees on portfolio investments that have not yet been made? Mr. Jacksha said that in the private equity market, it takes some time for appropriate investments to be made. The fees that the ERB pays are based on the money committed, rather than on the money invested. Of the $2.3 billion committed toward private equity, $943 million is still unspent.
- Did the ERB perform a fee study similar to the extensive study commissioned by the PERA? Mr. Jacksha said that the ERB did a fee study that was somewhat similar to that of the PERA, but the study did not include individual investment managers. That analysis is continually done by the ERB, however.

Report on ERB Experience Studies

Jan Goodwin, executive director, ERB, gave a report to the committee about the 2008-2014 experience study performed for the ERB by the actuarial firm Gabriel Roeder Smith & Company. The study is periodically performed in order to answer several questions about each actuarial assumption in the ERB pension plan, including: "What was the plan's actual experience?"; "How does that compare with current assumptions?"; and "Is a change in an assumption warranted?". There are many types of assumptions that are built into a pension plan's net pension liability, including mortality rates, retirement and termination patterns, investment return rates, the inflation rate, salary expectations and general economic assumptions. Keeping assumptions up to date will keep the actuarially determined contribution rate (the theoretical amount needed in contributions to make the pension plan 100 percent solvent) more stable and will more accurately reflect the actual funded ratio of the plan.

Results of the study of several assumptions include:

- Inflation. The 3.00 percent inflation rate is expected to continue unchanged.
- Investment Return. The 4.75 percent net real return and the 7.75 percent nominal return assumption are expected to continue unchanged.
- Annual Cost-of-Living Allowance (COLA). The 2.0 percent COLA (less the statutory reductions until the pension plan is fully funded) is expected to continue unchanged.
- Wage Inflation. The 4.25 percent annual wage inflation should be reduced to an expected 3.75 percent.
- Payroll Growth. The 3.5 percent annual payroll growth is expected to continue unchanged.
- Mortality. Current mortality rates are factored using static tables; emerging best practices recommend that there is an expectation of improvement in mortality rates each generation. The new expectation is that annual mortality rates will be decreased by four percent per year for males and one percent per year for females, using the most recent static tables.

The net result of the changes in assumptions had a small impact on the ERB's funded ratio, reducing it from 63.1 percent to 62.0 percent funded and increasing by six years the expected 100 percent funded date to 2046.

Questions and comments from committee members included the following.

- Has the ERB had the same actuary for the past 20 years? Ms. Goodwin said that the ERB puts out a request for proposals for an actuary every four years. The same firm has won the bid for the past 20 years.
- How was the investment rate of return determined? Ms. Goodwin said that the ERB asked eight separate consultants to review the current discount rate of 7.75 percent. The results of those consultants confirmed that the current rate is appropriate.
- ERB staff was asked to present to the committee a comparison of employer and employee contribution rates and investment return rates for states similar to New Mexico.
- There needs to be some sort of automatic procedure to ensure actuarial soundness of the state's pension funds, in case another economic downturn occurs. Ms. Goodwin said that long-term trends are more important than brief economic snapshots. Prior to 2013, the ERB was expected to eventually run out of money; today, it is expected to be fully funded by 2046.
- The biggest mistake the state ever made regarding pension plans was to allow for 25 years of service to qualify for retirement. In the 1990s, when those changes were made, the legislature was promised double-digit investment return rates for the long-term. That prediction abruptly fell short of expectations after the stock market crash of 2001.

Update on the SIC's Management of the Severance Tax Permanent Fund (STPF)

Steve Moise, state investment officer, and Charles Wollmann, director of communications and legislative affairs, SIC, presented to the committee an update on the management of the STPF. Mr. Moise began by posing the question of whether using the STPF to fund the mandates of the *Zuni* lawsuit settlement for school construction was the best use of that revenue stream. Contributions to the fund have dropped so much, and the fund has hardly grown in the past 15 years, that the fund is no longer achieving intergenerational equity for New Mexicans. The current value of the fund, as of May 31, 2015, was $4.776 billion, which matches the previous highest level from 2007. In 2007, 85 percent of the STPF was invested in "risk" assets, and when the economic downturn came in 2008, the fund's value plummeted to $3.1 billion. The fund's asset allocation was restructured, and the fund has achieved a five-year return average of 10.1 percent. The problem, however, is with contributions to the fund, which have been inconsistent and often very small. For example, in fiscal year 2015, the state collected $486 million in severance taxes, but contributions to the STPF were only $97.18. Distributions from the fund are set at 4.7 percent of the five-year rolling average of the fund and are expected to top $200 million in fiscal year 2017. Strong investment returns are not enough to guarantee the growth of the fund, since distributions from the fund are not offset by contributions to the fund in a meaningful manner.

In 2015, the legislature enacted legislation to incrementally increase the contributions to the STPF from the Severance Tax Bonding Fund from a theoretical five percent of the annual bonding capacity (after setting aside money for future bond payments) to a more reliable 13.8 percent of bonding capacity. This increase in contributions to the STPF will allow the fund's growth over the long term, rather than the previous expected stagnation of the fund's growth. This potential growth can be appreciated by comparing the growth of the Land Grant Permanent Fund (LGPF) since 2000 with that of the STPF. Both funds performed somewhat similarly in terms of investment return, but the LGPF has also seen significant contributions each year. In fiscal year 2000, the STPF was valued at $4.2 billion, and the LGPF was valued at $7.9 billion. In fiscal year 2015, the LGPF was valued at nearly double its 2000 value, but the STPF has barely grown and is valued today at $4.8 billion.

Another factor limiting growth of the STPF is a law requiring that part of the fund be invested in differential rate investments intended to stimulate the New Mexico economy. These economically targeted investments (ETIs) are mostly permissive, except for the requirement that one percent of the fund be invested in the Small Business Development Corporation for loans to small businesses. The impact of ETIs on the STPF, according to the LFC, is a one percent opportunity cost, or $40 million annually, versus investing in market rate investments.

Questions and comments from committee members included the following.

- The loss of uranium mining in New Mexico also had a big impact on the STPF's growth. The legislature has recognized the importance of infrastructure needs by using severance taxes to fund capital projects. There are other more pressing issues than the growth of the STPF.
- Is the SIC prepared for another stock market correction? Vince Smith, deputy state investment officer, SIC, said that there is currently very little cushion between equity and bond rates. The SIC has increased investment in income-producing assets and will be better positioned against a correction in a few years.
- Capital outlay projects generate jobs and improve the economy, not to mention the infrastructure improvements that improve the quality of life in the state.
- SIC staff was requested to work with staff of the ERB and PERA to develop a consistent methodology of reporting management fees and other data to the legislature.

Report on the SIC's Investment of the STPF in New Mexico Private Equity Funds and New Mexico Businesses

Lee Rand, managing partner, Sun Mountain Capital, gave a report to the committee about the New Mexico Private Equity Investment Program (NMPEIP). The program was established in 1993 to make investments in venture capital firms that in turn make investments in New Mexico businesses. From 1993 to 2003, the program was managed as a differential rate program, with the emphasis on economic stimulus and job creation. Since 2004, the program has been managed with financial returns as the primary focus, with economic development benefits as a secondary consideration. Since 2004, financial returns have improved dramatically. The first 10 years returned -18.2 percent, compared to the past 11 years returning 22.9 percent.

In fiscal year 2014, the STPF received distributions of over $20 million from 11 different venture capital funds from profitable companies. That year also saw two notable exits of Lumidigm and WellKeeper, as well as two successful initial public offerings. The program also works closely with partners to foster small technology company creation and growth. Funding commitments totaling $50 million were made through the program. The SIC approved an investment pacing strategy to keep five percent of the STPF invested in the NMPEIP. Sun Mountain Capital provides to the SIC annually a pacing update estimating the amount of money that can be responsibly invested in New Mexico businesses.

At the end of calendar year 2014, the program had a total of $297 million invested, with a corresponding $2.2 billion invested in those companies by external funds. Seventy companies have been invested in, with 37 companies still active. Eleven of those companies exited the program at a gain, and 22 exited at a loss.

Questions and comments from committee members included the following.

- There is still a significant lack of accessible capital for small businesses. Mr. Rand agreed, and he said that the NMPEIP is focused on growth-stage businesses. Many investment professionals in the state have been talking about the need for capital at various stages of business development. Early capitalization is usually a high-risk investment.
- Local business incubators are always needing more money to be able to get small businesses to the next level. Mr. Rand said that investors need to be able to get a return on an investment. The NMPEIP may need to look beyond the high-technology sector for investment opportunities.
- SIC staff was requested to provide better job-creation statistics for jobs generated by the NMPEIP. Mr. Wollmann said that the SIC is working with the Workforce Solutions Department to get better data on job creation.

Adjournment

There being no further business, the committee adjourned at 3:16 p.m.